Indebtedness of Microcredit Clients in Kosovo

Results from a comprehensive field study

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OBJECTIVES OF THE STUDY

The European Fund for Southeast Europe (EFSE) commissioned a study[1] to assess whether there is a problem of (over-) indebtedness among microcredit clients in Kosovo. Kosovo was the second country, after Bosnia and Herzegovina, where research on microcredit client over-indebtedness was conducted. The objectives of the study were (i) to gain an understanding of the level of indebtedness and underlying borrowing patterns of microcredit clients, (ii) to identify factors on both the demand and supply side which led to or prevented over-indebtedness, and (iii) to provide recommendations on how to prevent over-indebtedness.

METHODOLOGY

Sample. The study was conducted between September 2010 and July 2011 on a sample of 1,200 microcredit borrowers of four leading microfinance institutions and three banks. The sample was drawn proportionally reflecting each institution's share of the microcredit[2] market. Clients of the participating institutions were randomly selected to assure the validity and representativeness of the data. Given the scale of outreach of the participating institutions, the results stand for 83% of the microcredit market in terms of the number of borrowers.

Approach in two stages. In a first stage, a quantitative analysis was conducted based on secondary data of 1,200 clients from two sources: (i) data on borrowings and guarantees as reported to the credit registry (CRK) administered by the Central Bank (status 31st October 2010), (ii) data on household demographics and income from client files of the respective microcredit provider. The analysis resulted in a fair picture of the borrowing patterns and the (over)indebtedness of the sample clients.

In the second stage of the study, factors influencing indebtedness levels were identified. On the supply side, interviews were conducted with 18 credit managers, branch managers, and loan officers of the participating institutions. On the demand side, a survey was conducted among 778 clients of six participating institutions.[3] At a response rate of 80%, 619 interviews were finally conducted in April-May 2011. The remaining 20% of clients refused to participate in the survey, emigrated from the country or were out of reach for other reasons.

[1] The study team comprised Justyna Pytkowska (Microfinance Centre), Klaus Maurer and Sylvia Spannuth (Finance in Motion on behalf of the EFSE Development Facility). The field interviews in Kosovo were conducted by Index Kosova.

[2] Microcredit was defined as a credit contract for business purposes equal to or lower than EUR 10,000 at disbursement.

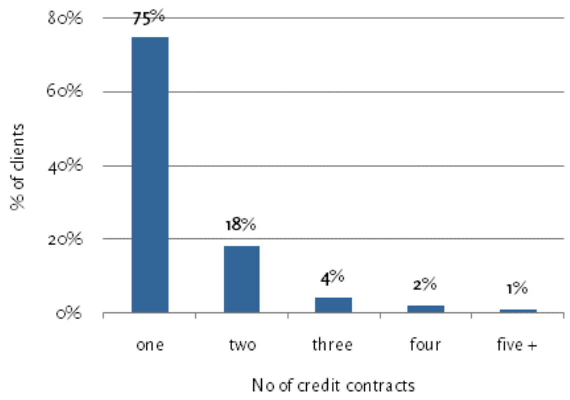
[3] At that point, one institution dropped out from the project.

The main findings of the study are presented in the following.

BORROWING PATTERNS

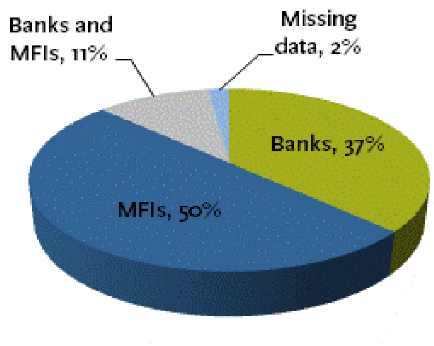
One quarter of borrowers have multiple loans. Credit registry data showed that 75% of microcredit clients had just one active credit contract (Chart 1). Clients had on average 1.4 outstanding credit contracts with the maximum of 8. Regular loans from MFIs and/or banks are the most common product. The use of overdrafts and credit cards is very low, constituting respectively 5.9% and 1.8% of all active contracts.

Chart 1: Multiple Borrowings



Cross-borrowing from different types of institutions is relatively rare as the majority of borrowers is repaying just one loan. As a result, only 11% of all microcredit borrowers were at the same time clients of banks and MFIs (Chart 2). However, when looking at the sub-sample of clients with multiple loans, it turns out that as many as 44% borrow concurrently from banks and MFIs. This indicates an overlap and integration of the microcredit and the banking sectors.

Chart 2: Source of Credit (% of Clients)



Cross-borrowing from different institutions increases with the number of active credit contracts. On average, one client used loans from 1.2 different institutions concurrently; at the extreme, one client had loans with 4 institutions.

REPAYMENT PERFORMANCE

8.4% of clients are overdue on their loan repayments for 30 days or more. While the majority of clients (91.6%) manage to make their monthly repayments on time or within 30 days, 4.5% have at least one contract in arrears between 30 and 180 days, while the contracts of 3.9% of clients are overdue for more than 6 months (Table 1). The total value of the outstanding portfolio which is overdue for more than 30 days amounts to 7.6%. Among overdue clients, the majority are late on just one credit contract.

Table 1: Repayment Performance

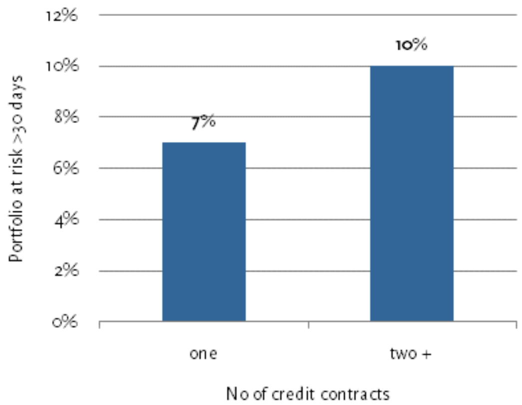
Repayment	% clients	% portfolio
On time or overdue < 30 days	91.6	92.4
Overdue 30-60 days	1.8	0.9
Overdue 60-90 days	0.9	0.4
Overdue 90-180 days	1.8	1.1
Overdue >180 days and written-off	3.9	5.2
Total	100	100

Repayment performance started deteriorating in 2009. The share of delayed repayments more than doubled compared to 2008 as it grew to 3%. However, the largest increase in the number of overdue repayments was observed in 2010. On average, 5.8% of monthly repayments made during the year were overdue for more than 30 days.

The study identified a number of factors that influence the repayment performance:

Repayment problems are more frequent among clients with multiple loans. The depth of repayment problems increases with the number of loans. While 7% of clients with a single loan are overdue by more than 30 days, the figure increases to 10% among borrowers having two or more loans (Chart 3).

Chart 3: Multiple Borrowings and Repayment Performance



Repayment performance on MFI loans is worse than on loans from banks. More than twice as many MFI contracts (10%) were overdue by more than 30 days compared to those of banks (4%).

Repayment discipline loosens as the loan gets closer to maturity. 8.5% of loans which are in the second half of their term are repaid with at least 30 day delay while only 1.6% of those before the mid-term are overdue for more than a month.

Loan contracts with larger original amounts are more often overdue. Loan contracts that are overdue by more than 30 days were on average by one-third larger at disbursement (EUR 5,850 versus EUR 4,410).

Repayment performance was also worse among clients with higher indebtedness. Excessive debt was associated with delayed repayments. The next section sheds more light on this relationship.

OVER-INDEBTEDNESS

Definition. The level of indebtedness was assessed using two measures: (i) objective measure: debt service payments in relation to net income (net indebtedness index) and (ii) subjective measure: the perception of debt burden.

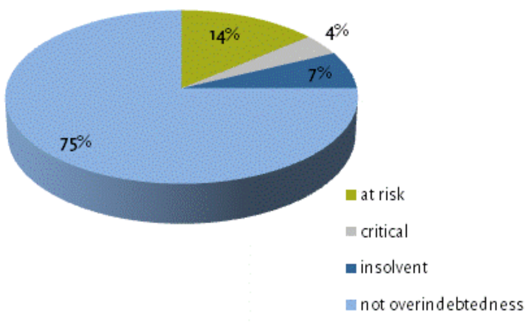
Objective measure. A *Net Indebtedness Index* was calculated using the following formula: *total monthly instalments on household debt/net monthly household income*[4]*.* Based on the calculation of the net indebtedness index clients were classified into four groups:

- Insolvent – if the client spent all net income of the household on debt servicing – net indebtedness index equal or exceeding 100%
- Critical – if the client spent between 75% and 100% of the household net income on debt servicing – net indebtedness index between 75% and 100%

[4] Net monthly household income = total monthly gross income of the household – total monthly expenses of the household

- At risk of becoming over-indebted – if the client spent between 50% and 75% of the household net income on debt servicing – net indebtedness index between 50% and 75%
- Not over-indebted – if the client spent less than 50% of the household net income on debt servicing – net indebtedness index below 50%

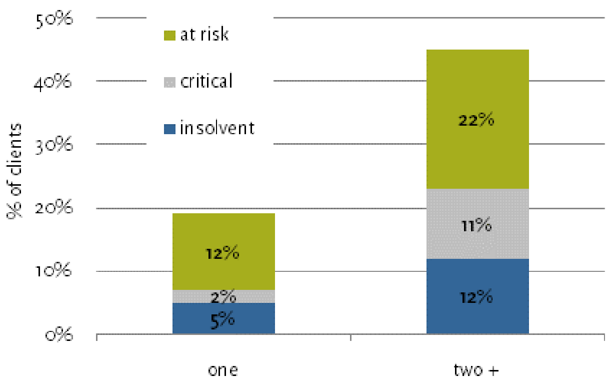
Chart 4: Level of Indebtedness (Objective Measure)



25% of the microcredit clients are seriously over-indebted or at the risk. While only 7% of clients spend all their disposable income on debt repayment, 4% are in the critical situation of spending three quarters of whatever money is left in the household after meeting all necessary expenses. 14% are regarded as being at the risk of becoming over-indebted, as the amount spent on debt servicing every month exceeds 50% of their net household income.

Multiple borrowing and over-indebtedness go hand in hand. The level of indebtedness increases with the number of active loan contracts. Among clients with a single loan only 5% are insolvent compared to 12% of those who have two or more loans. Also, the share of the clients facing a critical situation and those at risk increases significantly with the number of loans (Chart 5).

Chart 5: Multiple Borrowing and Over-indebtedness (Objective Measure)



Over-indebtedness is more often seen among experienced clients. Insolvent clients were, on average, in the fourth loan cycle, while not over-indebted clients in the second (Table 2).

Table 2: Average number of past credit contracts by indebtedness class

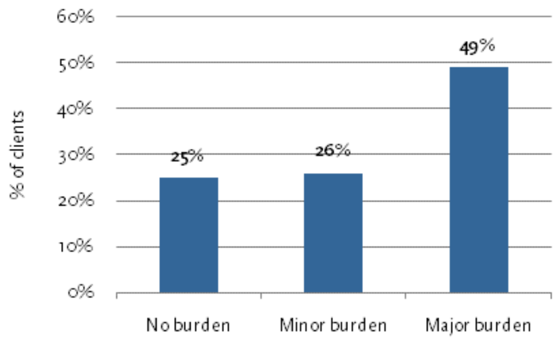
Indebtedness category	Average number of past credit contracts
not over-indebted	1.9
at risk	2.5
critical	2.4
insolvent	3.9

Gender-related differences in over-indebtedness were mixed. Women less often were found to be insolvent (3% of women versus 7% of men) but were more likely to face a critical situation or to being at the risk of becoming over-indebted.

Subjective measure. The perception of debt burden was assessed based on a sub-sample of the respondents to the client survey. Clients were asked to state to what extent debt repayment had been a burden on their household finances.

Almost half of the respondents (49%) feel that loan repayment has become a major burden. At the same time, only a quarter feels no financial burden associated with credit (Chart 6). While this burden has been permanent for 30%, for 34% it has only started recently.

Chart 6: Level of Indebtedness (Subjective Measure)

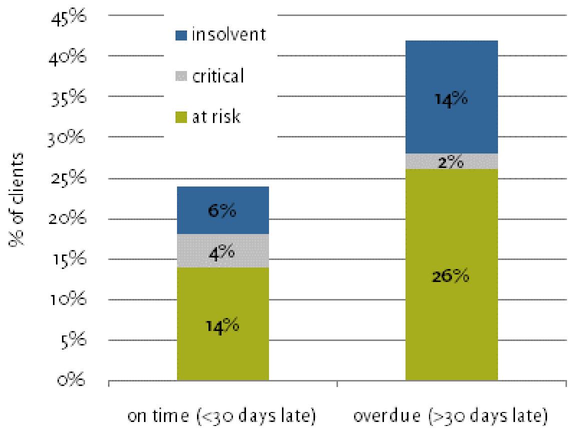


Reasons for the perception of being debt-burdened are changes in income and expenses. Clients attributed the feeling of debt burden to increases of living costs (82% of clients feeling burdened), lower income (72%) and unexpected expenses (25%). Those who did not feel a debt burden at all attributed it chiefly to income stability (42% of the respondents who felt no debt burden) and their own abilities - good money management (31%) or wise borrowing, that is knowing own repayment capacity (23%). Only 2% gave credit to the financial institution for not disbursing a too large loan.

INDEBTEDNESS LEVEL AND REPAYMENT PERFORMANCE

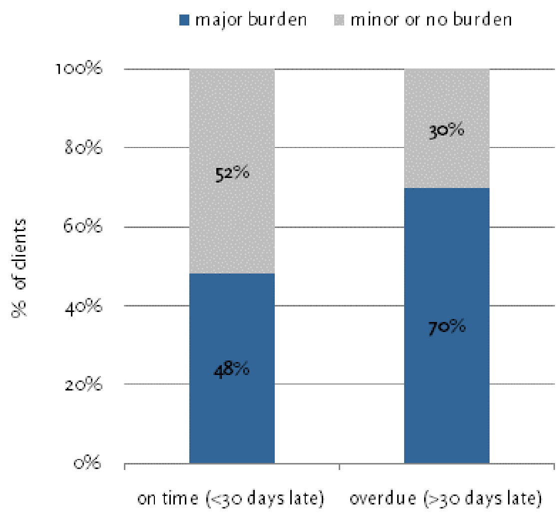
Repayment performance is correlated with the level of client indebtedness. Clients with overdue repayments for more than 30 days were more than twice as often insolvent and almost twice as often at the risk of becoming over-indebted (Chart 7).

Chart 7: Repayment Performance and Over-indebtedness (Objective Measure)



Clients who felt a major debt burden more often repaid with a delay. However, it should be noted that the vast majority of microcredit clients (feeling debt-burdened or not) managed to make loan repayments within 30 days (Chart 8).

Chart 8: Repayment Performance and Over-indebtedness (Subjective Measure)



Additional jobs or savings are the most common mechanisms for coping with income shortages. Savings, in particular, are found to be effective in easing the debt burden. Clients who used savings for debt repayments less often felt a major debt burden compared to those who had to borrow from family or friends in order to keep up with the repayment schedule.

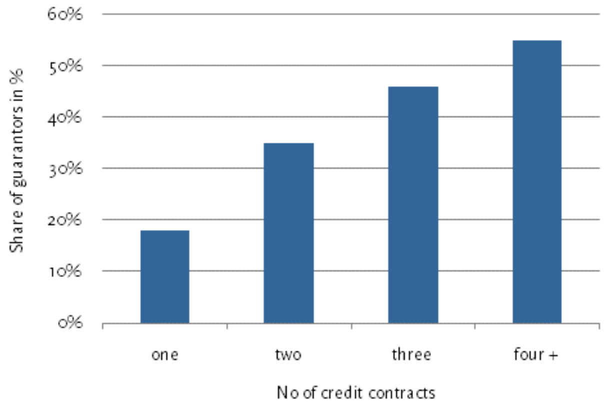
However, the inter-relation between over-indebtedness and repayment problems is ambiguous. Although over-indebtedness determined by the net indebtedness index and by the subjective feeling of debt burden correlated with the repayment performance, no direct relationship between the two indebtedness measures were found.

GUARANTEES AND CO-DEBTS

Almost one quarter of the borrowers are guarantors for others. Quite a significant share of clients (23%) acts as guarantors and is registered as such in the CRK database. In fact, even more people are liable for other people's credit. Those who act as co-debtors (11% of clients) are involved in monthly repayments, although the extent of this engagement is unknown. In some cases, co-debtors are other household members (a spouse) and therefore participate in the repayment which is made from the common household budget. In other cases, the role of a co-debtor is very similar to that of the guarantors – they are asked to contribute to the repayment only if the main borrowers cannot repay.

Taking multiple loans is correlated with providing guarantees for others. The more loans people take for themselves, the more guarantees they provide for others. Among clients with single loans, only 18% provide a guarantee for other people (Chart 9). The guarantor share rises to 55% for clients who have taken four or more loans for themselves. On average, a guarantor provides 1.8 guarantees, with the maximum of 14 guarantees.

Chart 9: Multiple Borrowing and Guaranteeing Others



Clients who guarantee overdue contracts more often experience repayment problems with their own loans. 33% of borrowers who guarantee overdue loans are late for more than 30 days on their own repayment compared to only 5% among those who guarantee timely contracts. This might be a result of the fact that these clients contribute to the repayment of guaranteed loans and are thus unable to meet their own debt obligations.

Similar relationship is seen between the repayment performance of co-debts and own loans. 60% of the borrowers whose co-debts are delinquent for more than 30 days are untimely on the repayment of their own loans. However, the scale of this incident is very small as the overwhelming majority of co-debts have a healthy repayment record.

FACTORS THAT INFLUENCE THE LEVEL OF INDEBTEDNESS

The following two **external factors** affecting/preventing over-indebtedness were analysed: (i) effects of external shocks and coping mechanisms and (ii) the role of the credit registry.

The relatively low negative impact of the financial crisis prevented over-indebtedness on a large scale. The economic decline was not as severe in Kosovo compared to other countries and started later than in the neighboring countries.

The availability of coping mechanisms in case of income shocks allowed borrowers to keep up with their repayment schedule. Although about half of the clients interviewed experienced a deterioration of their financial situation during the crisis, the majority of clients have still managed to meet their repayment obligations. For instance, having savings significantly improved the repayment performance and relieved the feeling of debt burden.

Operations of the credit registry have played an important role in preventing over-indebtedness. The current credit registry has been operating since 2003 with all credit providers (banks and MFIs) submitting client data since 2006. Interviews with banks and MFIs revealed that the CRK records of loan applicants, including co-debtors, and the immediate family are always used in the credit decision process. Data is almost available "real time" which plays a crucial role in preventing clients from taking loans from several institutions at the same time.

On the **supply side**, two main factors were found to be influencing the indebtedness of microcredit clients: (i) intensity of marketing and (ii) lending behaviour.

Indications exist that microcredit providers have not engaged in unfair competition and excessive lending. Although high portfolio growth was observed in 2007-2008 and competition has been strong, indications exist that microcredit providers, even in the period of high growth, have not engaged in excessive lending and unfair competition. It seems that sales techniques were balanced and, in principle, clients were not pushed into taking loans. Thanks to the availability of high quality historical client information from the credit registry, a careful assessment of the repayment capacity of prospective clients has been possible.

The analysis of the characteristics of the clients who feel overburdened with debt led to the identification of a variety of **demand side factors** significantly associated with the perception of debt burden.

These included:

- **external factors** – incidence of adverse events affecting financial standing
- **demographic characteristics** – unstable income sources, poverty, poor health
- **financial behaviour** – lack of savings, no financial planning, borrowing from family
- **psychological characteristics** – external locus of control, low self-discipline, overconfidence bias, lack of debt aversion
- **sociological characteristics** – low social comparison, lack of economic socialisation

The actual amount of debt did not influence the perception of debt burden. Rather, low and unstable income, the lack of back-up resources coupled with some cognitive biases such as the general feeling of no control and low self-discipline most strongly impacted the perception of debt-related strain, especially in the presence of adverse economic events.

PUTTING THE PIECES TOGETHER: MULTIPLE CORRELATION AND COMPLEX INTERDEPENDENCE

The relationship between the repayment performance, indebtedness level and a number of other factors is complex. Higher indebtedness levels coupled with certain borrowing patterns, external factors, borrower characteristics and behaviours lead to higher repayment problems. However, even though multiple borrowing is associated with more delays in loan repayment and a higher net indebtedness index, it does not affect the perception of debt burden, which is much less influenced by the borrowing patterns than by the financial standing of the household.

The household's financial standing, in turn, expressed by the poverty level, income stability, as well as the availability of cash assets, affects not only the subjective debt burden but also the actual timeliness of repayments.

All in all, the likelihood of repayment problems is higher in the final stages of the loan repayment term of non-bank loans, among clients with more than one active credit contract who are additionally engaged in overdue co-debts or guarantees and who are over-indebted. Indirectly, the repayment performance is influenced by the credit history, as clients with a larger number of past credit contracts tend to have a higher net indebtedness index.

Additionally, psychological predispositions such as a short-term perspective and focus on present time, as well as the general perception of little control over one's own life deepen the feeling of debt burden, which affects the repayment timeliness.

RECOMMENDATIONS

Based on the results of the study, recommendations for key groups of industry stakeholders were developed. Three main areas were identified in which actions can improve the current situation and prevent the deepening of indebtedness: (i) transparency and information sharing about credit activities (ii) responsible lending practices, and (ii) financial education of clients.

Microcredit providers

1. Periodically update information on client income and debt load. The perception of debt being a major burden on the household budget affects the repayment performance. Furthermore, the results showed high volatility of income and changes in the number of active loans over time which leads to the deterioration of repayment timeliness during the repayment term.

Therefore, it is advisable that financial institutions periodically update debt-to-income information on their clients during the loan term by verifying their income level and monitoring their engagement in debts from other institutions through CRK data checks. This will allow the credit providers to identify the risk of default and employ preventive measures.

2. Continue responsible lending. Interviews with credit providers showed that unfair lending practices are rather rare, despite some evidence of high competition and documented periods of strong sector growth. It is advisable that microcredit providers continue to apply responsible lending practices and do not engage in risky lending.

Association of Microfinance Institutions in Kosovo (AMIK) and Kosovo Bankers' Association (KBA)

1. Promote transparency about credit operations. Several credit providers expressed the need for more information about credit operations of banks and MFIs in different geographic regions and with different types of clients (micro, SME, different types of businesses and loan types). Therefore, it is recommended that both associations collect and disseminate more detailed monthly statistics.

2. Promote good money management among borrowers. Borrowers who have good financial habits (e.g. budget planning) were found to feel less burdened with debt and to repay their debt more timely. The associations could, together with microcredit providers and other relevant financial sector stakeholders, promote good financial practices among microcredit clients through financial education workshops, advisory services, brochures, leaflets, etc.

Central Bank of Kosovo (CBK)

1. Publish more detailed information about the development of different segments of the credit market. Several financial institutions interviewed during the project expressed the need for more information about the volume of credit disbursed in the micro, SME and corporate segments. Currently, the Monthly Statistical Bulletin of CBK provides only information about the volume of commercial bank loans to business clients but the information is not further disaggregated by business size. Therefore, the actual value of microcredit disbursed by banks remains unknown.

2. Set up an analytical function specifically for the analysis of credit registry data. In addition to the previous recommendation, CBK should also regularly analyse and publish statistics on the repayment performance of different types of credit, using the data collected by the CRK. The analysis conducted during this study can serve as an example for further replication. Additionally, examples of the reports published by credit bureaus in other countries can be used to design a set of publications which will be produced periodically based on credit registry data. In addition, the historical analysis of loan use and repayment performance would allow understanding the trends and benefit the sector.

3. Promote financial literacy among borrowers. CBK, together with other relevant financial sector stakeholders, could play a role in improving financial literacy among the population, e.g., through public information campaigns, educational web portals, publications, etc.

Credit registry (CRK)

1. Collect information about monthly/quarterly/semi-annual instalment size. Currently, financial institutions cannot verify the total amount of repayments a client applying for a loan makes to other financial institutions he is indebted with. Such information would allow for a better assessment of the repayment capacity, as the financial institution considering the new loan disbursement will have an opportunity to know the cost of debt service on the loans currently being repaid by the borrower.

2. Include information about loan rescheduling. Currently, loans which have been rescheduled are not clearly marked as such in the CRK records. A financial institution, when checking the credit standing of a prospective client, is not aware of changes in the loan contract. Such information should be available as it will significantly improve the quality of the client assessment.

3. Further strengthen the credit registry scope of data. In order to be able to cover the full extent of the debt of borrowers, it is recommended that all financial providers are included in the reporting to CRK. Efforts are currently under way in Kosovo to integrate the reporting of insurance providers and, in the medium term, to establish a link/interface with the utility sector to be able to better assess the payment obligations of clients.

Investors/Donors

1. Support CBK in developing an analytical and reporting function. Investors/donors can contribute to improving the capacity of the relevant staff at the Central Bank to regularly produce credit market reports. This can be achieved by a combination of expert technical assistance and/or peer exchange visits to credit bureaus and national banks in other countries.

2. Support MFI and Bankers' Association in developing new functions. Investors/donors can contribute to the development of new services by financing technical assistance and peer exchange visits to associations which are more advanced in areas such as member statistics reporting.

3. Support initiatives promoting financial literacy. Investors/donors can also support individual microcredit providers in developing financial education initiatives for microfinance clients.

4. Continue promoting responsible finance. The results of the study showed that, despite rapid sector growth and strong competition, financial institutions did not engage in excessive lending, thus protecting their clients from becoming over-indebted. Therefore, it is very important that financial institutions continue with such conduct and receive recognition and support from investors and donors who provide funds for on-lending.

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